

**HUNTON & WILLIAMS  
USAID UKRAINE**

**ENERGY LEGAL, REGULATORY  
AND MARKET REFORM PROJECT**



Prepared for:

U.S. Agency for  
International Development

IOC No:

EEU-I-00-99-00033-00

Task Order No:

OUT-EEU-I-800-99-00033-00

1<sup>st</sup> QUARTERLY REPORT

MAY 2000 – AUGUST 2000

Tom Broderick  
Contracting Officer  
U.S. Agency for International Development  
Regional Mission for Ukraine, Belarus & Moldova  
19 Nizhniy Val St.  
04071 Kyiv, Ukraine

31 August 2000

**RE: Task Order Out-EEU-1-800-99-00033-00**  
**Energy Legal, Regulatory And Market Reform Project**  
**Quarterly Report for May 15 2000 Through August 2000.**

Dear Paul,

Enclosed is the Quarterly Report for the period of inception of the project on May 15 2000 through the end of August 2000 as required by our Task Order OUT-EEU-1-800-99-00033-00 for the Ukraine Energy Legal, Regulatory and Market Reform Project. We provide this to you at the CTO or our Scope of Work.. We expect to provide a more detailed "Inception Report" at the end of the second quarter of work, in December 2000.

Sincerely,

Paul Ballonoff  
Chief of Party,  
Hunton & Williams,  
Kiev Project Office

Cc: Paul F. Mulligan  
Director, Office of Economic Restructuring, USAID

Julia Weller  
Project Director, Hunton and Williams

**HUNTON & WILLIAMS - USAID UKRAINE  
TASK ORDER OUT-EEU-1-800-99-00033-00  
ENERGY LEGAL, REGULATORY AND MARKET REFORM PROJECT**

**QUARTERLY REPORT: MAY 2000 – AUGUST 2000**

**A. PURPOSE AND OUTLINE OF QUARTERLY REPORT**

**A.1. PROJECT PURPOSE AND FOCUS OF WORK**

Hunton & Williams has been awarded Indefinite Quantities Contract EEU-I-99-00033-00 (the “IQC”) by the United States Agency for International Development (“USAID”) through which USAID awarded Task Order OUT-EEU-I-800-99-00033-00 (the “TOR”) to Hunton & Williams to provide certain legal, regulatory and wholesale electricity market advisory services in support of Ukraine’s energy sector privatization program (the “Project”). To those ends, we are expected to, and successfully do, work with diverse counterparts within the Government of Ukraine (“GOU”) as well as coordinate our activities among the international donor community. Based on our experience to date, we can best summarize the work as principally serving three functional headings, working to:

- ***Strengthen the independence and functionality of the power sector regulator*** – presently the National Energy Regulatory Commission (“NERC”);
- ***Improve the operation and governance of the wholesale electricity market*** (“WEM”); and
- ***Ensure the success of GOU’s energy sector privatization program*** in concert with USAID contractor Deloitte Touch Tomatsu (“DTT”) – the USAID contractor with primary responsibility to advise the State Property Fund of Ukraine which conducts the privatization of all state entities as the agent of the government.

To achieve each of these goals, we actively work with all GOU counterparts – the Verkhovna Rada of Ukraine (the “Verkhovna Rada”), NERC, the Ministry of Fuel and Energy (“MFE”) and Energorynok State Enterprises (“Energomarket”) – to identify the impediments to achieve our goals, develop precise mechanisms to remove those impediments and then implement those mechanisms.

Specifically, to strengthen NERC, we are implementing the following initiatives:

- Pass new legislation that provides political and financial independence and establishes standards for the energy sector that shall be regulated by NERC.
- Detail a tariff methodology responsive to the privatization effort and current market realities.
- Develop a mechanism for modifying the NERC-established algorithm that controls the flow of funds through the WEM.

To improve operation and governance of the WEM, we are pursuing the following objectives:

- Assist the executive board of the WEM (the “WEM Board”) – created by the agreement signed on 15 November 1996 by all WEM participants (the “Members’ Agreement”) – to contract for an independent auditor to scrutinize the flow of funds and power through the WEM transit accounts and Energomarket, the WEM settlement administrator.
- Implement appropriate legislation on the WEM structure that completes the existing WEM framework established through the Members’ Agreement.
- Prepare the WEM for a fully functioning WEM, including bilateral contracting, by improving information technology and metering at the WEM and Energomarket levels.

To ensure the success of GOU’s energy sector privatization program, we are undertaking the following:

- Advise DTT and Credit Suisse First Boston (“CSFB”) – the investment bank hired by GOU to conduct the first tranche of energy sector company privatization sales – to analyze the terms of the tender, the sale/purchase agreement consummating the privatization sale, and other documents fundamental to the privatization effort.
- Actively engage the MFE, the Energomarket, the Verkhovna Rada and the Cabinet of Ministers of Ukraine (“CabMin”) to develop an appropriate short- and long-term resolution to sector debt issues.
- Regularly meet with potential strategic investors to share our knowledge on legal and regulatory issues impacting the energy sector.
- Support the energy task force created by GOU and the international donor community – consisting of USAID, the European Bank for Reconstruction and Development (“EBRD”), the International Monetary Fund (“IMF”) and the World Bank – (the “Task Force”) through drafting joint documents and implementing the action items emerging from Task Force meetings.
- Coordinate work among the international donor community to ensure a common focus on and support of an acceptable outcome for GOU’s energy sector privatizations.

## **A.2. OUTLINE OF QUARTERLY REPORT**

This inception report summarizes the conditions found and results achieved for the first three months of the Project from inception on 15 May 2000 through 15 August 2000, the current status of work, and anticipated activities in the near to medium term.

This report consists of five sections:

- Part B compares the assumptions of the TOR to actual conditions found.
- Part C details our relationship with each GOU counterpart, highlighting the current focus of our work.
- Part D summarizes our work in direct support of the privatization effort, focusing on our support of DTT’s privatization program.

- Part E summarizes our work with the Task Force and the international donor community.
- Part F summarizes our intent to develop a training program.

## **B. TOR ASSUMPTIONS VERSUS REALITY FOUND**

The basic assumption of the TOR, as also reflected in the Project budget, was that our work would focus on technical development, such as putting in place tariffs and related regulations at the distribution and wholesale market levels that would support privatization. In the short term, the TOR seems to have envisioned that legal issues would be a primary focus of our work in the first year, creating the process of privatization in an organized and purposeful manner. The legal effort would run concurrently with putting in place a reformed WEM market structure. Thus, the budget assumed a resident legal specialist for one year, a resident market specialist for 18 months, and a legal-regulatory specialist for the full three years of the Project. Our expatriate staff was to be supported by a modest budget for as-needed advisors from the U.S. Technical advisors would assist primarily on tariff and legal tasks. The local staff budget assumed two Ukrainian attorneys and a translator, plus diverse part-time technical skills adding to approximately one full-time equivalent position assuming average local wages for Ukrainian support.

The reality has met these expectations only in part. Work to date has certainly emphasized legal issues, but not entirely in the form expected. As assumed by the TOR, our legislative effort has concentrated on a law for regulatory independence and on market structure issues. Contrary to our initial expectations, the Verkhovna Rada has proven far more open to work with the Project on a wider range of legislative issues than anticipated. We have therefore also been involved with legislative efforts to establish energy sector policy and resolve sector debt issues. Unexpected was the extent to which our legal effort would need to respond to a heavy load of essentially political actions. Many of these required a response not so much to positively create privatization, but to defend the degree of legal and regulatory reform that GOU has already achieved or that are the focus of current and/or future work.

These realities have affected allocation of Project resources. We have in place the three required resident advisors, whose efforts have been focused on technical support of the privatization effort, on containing political issues and on drafting and advising on Project-related legislation and normative acts. To support this unanticipated work, we have not used the technical assistance portion of the Project budget as such assistance would be premature given the lack of NERC independence and present uncertainties in the operation and governance of the WEM. Instead, we are using US-based legal assistance at a higher rate than initially assumed.



## **C. RELATIONSHIPS WITH COUNTERPARTS**

### **C. 1. BACKGROUND**

The TOR identifies four primary counterparts for the Project: NERC, the Energomarket, the Verkhovna Rada, and the MFE. The Memorandum of Understanding between the Government of the United States and the GOU, dated \_\_\_\_\_, (“MOU”) created the basis for establishing the relationships with the GOU counterparts identified in the TOR. We summarize our work to achieve Project goals with each GOU below.

We should note, however, that we experienced difficulty establishing relationships with two of our designated counterparts as a result of a structural change within GOU in late 1999 early 2000. The TOR was developed when the Energomarket was a part of Ukrenergo, presently the high voltage transmission company. The TOR called for us to work with Ukrenergo as its responsibilities included the power pool operations – a primary focus of our work – as well as the transmission and dispatch operations. At that point, Ukrenergo was also directly controlled by the MFE. By the time the Project commenced, GOU unbundled the power pool and the market clearing functions from the transmission and dispatch operations. The unbundling placed the wholesale market functions with the Energomarket and transmission and distributions functions with a separate operating entity also called Ukrenergo. Energomarket control was transferred to the CabMin, while Ukrenergo remained with the MFE.

GOU’s unbundling of Ukrenergo, while we view the separation as an efficiency gain to the market structure, created problems when formally commencing our work in Ukraine as the United States Government did not have an agreement with GOU to provide advisory assistance to the Energomarket – the MOU established a relationship with a now unbundled Ukrenergo. Additionally, this unbundling impaired our intended relationship with the MFE given that wholesale market functions no longer remained under its direct control. Nevertheless, we have recreated both relationships and are close to formally registering those relationships with the Ministry of Finance as is required by Ukraine law.

### **C.2. NATIONAL ENERGY REGULATORY COMMISSION**

In 1996, in part through the diligent efforts of USAID, the President of Ukraine created NERC by decree as an independent energy sector regulatory commission. Supporting NERC’s continued development and working with NERC to support GOU’s privatization effort remains a key focus of our Project. Project relations with NERC are good, bolstered, in part, through our second Project office located within the NERC building. We meet with NERC counterparts daily and have a routine, weekly meeting with the NERC Chairman and other commissioners to discuss and coordinate on-going issues. Through the first six months of the Project, four issues have dominated our work with NERC: draft law on regulatory commission; tariff methodologies and rate design; due process; algorithm. Each issue is briefly discussed below.

### **C.2.1. Regulatory Commission Law**

In summary, the focus of this work is to clearly establish NERC's political and financial independence, freeing NERC from outside influences. Achieving this objective is critical for increased stability in Ukraine's power sector and the continued success of GOU's energy sector privatization, as the current legal basis for NERC's authority permits interference from the CabMin and other third-party influences. We are currently advising the Fuel and Energy Complex Committee of the Verkhovna Rada on how to combine two drafts of this law, into one coherent draft covering critical issues for such a law, and resolving political differences between proponents.

### **C.2.2. Tariff Setting Methodologies and Rate Design**

Another critical issues for the success of GOU's privatization program is clarity in NERC's tariff setting methodologies and continued improvement of rate design. Since Project inception, Hunton & Williams' has worked with NERC on these fundamental issues. Our approach has taken several forms. Most of our assistance has been through our daily, "hands on" work with NERC from our NERC-based Project office. As previously mentioned, we have established good working relationships with NERC counterparts both at the staff and commissioner levels, and expect this will prove beneficial as the privatization itself approaches and tariffs become a critical issue.

### **C.2.3. Due Process and Regulatory Procedure**

A third issue that permeates our work with NERC is to assist NERC in devising a proper governance mechanism, injecting notions of due process, rule of law, and proper regulatory procedure into NERC's work so that NERC's activities reflect international standards. Our work on this issue became particularly important following the 22 June 2000 amendments to the Law of Ukraine "On Electricity" (the "Electricity Law"), as the amendments permit NERC to sanction a license violation by appointing a "trustee" to operate the licensee's company. The trustee issue reached a critical juncture in August 2000 when at the direction of the CabMin, NERC held a regulatory hearing to consider a possible violation of its license by failing to pay cash for electricity during the first six months of 2000. Driven by our belief that the imposition of a trustee violated the Ukraine Constitution and send the wrong message to strategic investors, we researched constitutional law issues and related law to determine if we could construct an argument against displacing this particular licensees' management with a trustee. Our research disclosed that NERC would likely violate the Ukraine Constitution if it imposed a trustee in the manner required by the CabMin. We shared our views with NERC through a letter attached in Annex C. Ultimate NERC followed our advice at the related regulatory hearing.

#### **C.2.4. Algorithm**

Finally, we have begun working with NERC to establish and implement a procedure for modifying the algorithm that currently allocates the flow of funds through the WEM transit clearing accounts mandated by the Electricity Law. We will discuss this in more detail in subsequent Quarterly Reports.

### **C.3. ENERGOMARKET**

As explained above, while initially we had no relationship with the Energomarket, we have successfully created one. From July 2000, when we began participation in Energomarket working groups to review proposed changes to the Members' Agreement, our relationship with the Energomarket has evolved into regular weekly meetings with the Director of the Energomarket and his key staff. We also hold technical working groups on tasks of common interest. These meetings act as steering committees for several concurrent projects that we have jointly developed with the Energomarket. Similar to our work with NERC, we have begun acting as a legal and technical consultant to the Energomarket for specific projects of common interest, including the specific actions mentioned below.

#### **C.3.2 Amendments To Members Agreement**

Also as a result of the Electricity Law, certain WEM Members and Project counterparts believed that aspects of the Members' Agreement conflicted with the amended law. Thus, the WEM Board established a task force to review and recommended changes to the Members Agreement. Hunton & Williams participated in this task force and commented on proposed changes. As we believed that the proposed changes were not appropriate at the time, we delivered a letter to the WEM Board and to the CabMin, explaining our reasoning, noting that any required revisions could be managed through amendments only to the contracts. We will attach this letter to our November Inception Report, which will be our next Quarterly Report

#### **C.3.3 Debt Issues**

A principal function of the Energomarket is to serve as the clearing house for market transactions and settlements. Thus, the severe electricity non-payment problem and consequent accumulated debts in the sector are a direct interest to the Energomarket. After a series of discussions between Hunton & Williams and the senior staff of the Energomarket, the Energomarket invited Hunton & Williams to assist in devising a mechanism to resolve the debt problems that have plagued the WEM. We identified three areas where our assistance would be useful, and thus, focused our work on the same. First, we are diligently working with DTT to secure an appropriate debt resolution mechanism to support the privatization program. Second we are working on devising long-term solutions to resolving debt for the entire power sector. Finally, we have identified inconsistencies in the way different GOU entities and power sector companies



record payments for debt and current obligations. This inconsistency exacerbates the debt situation, and thus, we are working with the Energomarket, the Ministry of Finance and other relevant entities to resolve the issue. Our work products on this issue will be included in our November Quarterly Report and Inception Report.

#### **C.3.4 Metering Issues**

Comprehensive and accurate metering are essential pre-requisites to implementing two key goals of our Project: bilateral contracting among WEM Members, and a system of billing and invoicing for a power pool. As such, Hunton & Williams is working with a committee of senior Energomarket staff to define the issues related to proper metering. Once we have outlined the parameters of the metering issue, we then intend to seek further assistance from the international donor community to further implement solutions to the metering issues.

#### **C.3.5 Information Technology Support**

Operation of a complex power pool with diverse members imposes a high burden of information technology coordination, ranging from security for emails to complete billing systems. These issues are critical to a properly governed market and the Energomarket has requested our assistance. The Project does not have resources to address the full range of possible information technology issues, but does have sufficient resources dedicated to this problem to provide limited technical assistance, including some mixture of equipment, software, training and consulting advice. Hunton & Williams, including our office information technology specialist, created a working group with the senior Energomarket staff to define the Energomarket's information technology requirements and how best to apply our limited resource.

### **C.4. MINISTRY OF FUEL AND ENERGY**

While we previously mentioned our difficulties in beginning our work with MFE, we have overcome those difficulties and are working them on a variety of critical issues affecting privatization, the most critical of which are restructuring sector debt and to continue the positive development of Ukraine's energy sector policy and WEM structure. Our work occurs through bi-weekly and "as needed" meetings with the Minister of Fuel and Energy, his deputy ministers, and the MFE staff. We expect progress on these issues and will discuss this topic in more depth in our November Quarterly and Inception Report..

#### **C.4.1 Sector Policy and WEM Structure**

A natural area of cooperation between our Project and the MFE relates to energy sector policy and, of greater concern to the Project, the structure of the WEM. Our work on these issues consists of two issues. First, on a broad level, we engaged the MFE in general discussions on wholesale market structure and policy issues, including the appointment of trustees as a license sanction. Second, we are working closely with the

MFE on developing amendments to the existing WEM Bill which could change the current landscape of the WEM.

Our discussions with MFE on the WEM Bill, together with our work with the FEC Committee on the same, have been guided by two sources: the executed minutes of the 16 June 2000 Task Force meeting and our meetings with potential strategic investors (e.g., Electricity d'France, AES Corporation, and Northland Power). Reflecting both of these sources, we have focused our work first on establishing a stable wholesale market structure and well-defined system of governance that can be used to efficiently and transparently address energy sector problems, modifying the existing wholesale market structure if appropriate. We are concurrently working to establish the necessary legal and technical tools to facilitate bilateral contracting between market members, as we mentioned above in C.3.5.

## **C.5. VERKHOVNA RADA**

The Project design assumed relationships with the Verkhovna Rada and, in particular, with the FEC Committee. Based on priorities proposed by the FEC Committee and our ability to meet those priorities within the Project scope of work, we devised a legislative program focused on ensuring a more successful privatization and post-privatization operation of the power sector. To meet our legislative efforts, we scheduled biweekly working meetings with the FEC Committee to discuss and address issues related to one or more laws related to the energy sector. The FEC Committee also invited Hunton & Williams' participation in four "task forces" or topical sub-committees addressing the following broad topics: NERC, wholesale electricity market, sector policy, and privatization. We have also been invited to work with them on oil and gas policy and regulatory issues, but due to resource constraints and policy directions from USAID, we have elected, for the current period, not to work on those topics. Below we describe specific legislative initiatives for which we are advising the FEC Committee.

### **C.5.1. NERC Bill**

The first topic for which we provided assistance to the FEC Committee is a bill to ensure the independence of the energy sector regulatory commission, presently NERC. NERC independence relates both to independence from political interference by third parties and also financial independence so that NERC avoids unnecessary budgetary pressures. In support of this law, Hunton and Williams has provided the Fuel and Energy Complex Committee of the Verkhovna Rada with detailed comments on each of several drafts of such a law, indicating the strengths and weakness of each. We have provided them memoranda outlining the technical requirements one would expect to find in such laws. We have provided them with detailed summary comparisons of world experience in establishing regulators, in India, Argentina, the United Kingdom and the United States. We meet regularly with the staff of this Committee. We shall report on further details of this work in our November Quarterly and Inception Report.

### **C.5.2 Wholesale Electricity Market Bill**

One of the fundamental tasks of our Project is to improve market governance of the wholesale electricity market. In late 1999, a bill restructuring the wholesale electricity market passed the Verkhovna Rada at first reading – the WEM Bill. As the bill passed a first reading, we have been forced to use the WEM Bill as the vehicle through which to implement changes to the WEM that will ensure its smooth functionality, removing problems with the current design. Some features of the WEM Bill are improvements on the current wholesale market design, and thus, Hunton & Williams has been working with the FEC Committee to redraft the WEM Bill to make it both more politically acceptable and also achieve the results that we seek. We should also note that the bill faces significant opposition as the coalition that passed the bill no longer commands a clear majority in the Verkhovna Rada. To overcome the change in the political landscape, we are working with other counterparts – the MFE, the Energomarket and NERC – to involve them in developing amendments to the WEM Bill, generating a broader support base for the bill. We believe the political discord on the bill will likely push any vote on the bill into the first half of 2001. We will discuss the development of the WEM Bill in later Reports as we further develop our relationships with counterparts.

### **C.5.3 Energy Sector Policy Bill**

A third key legislative initiative of by the FEC Committee is the development of an energy sector policy bill. Regulatory laws in western countries commonly state both policy purposes to be achieved by such laws and performance standards in the implementation of those policies. In Ukraine, regulatory laws typically contain limited statements of policy, and few or no statements of performance standard. Administrative orders from the executive branch of government – the President or the CabMin – fill such legislative policy vacuums. Rather than leave such important decisions to fate, the FEC Committee decided to develop an energy sector policy bill that would identify energy sector policies and standards. While only in the infancy stage, Hunton & Williams is working with the FEC Committee to review and comment on drafts of this energy sector policy bill. We shall Report on this work in later Quarterly Reports.

## **D. RELATIONSHIPS TO PRIVATIZATION**

USAID's primary privatization advisor to the State Property Fund is DTT. Nevertheless, Hunton & Williams is directly assisting the privatization effort, while continuing our focus of developing the legal and regulatory support to both prepare and sustain Ukraine's power sector for privatization. Aside from our daily interaction and input to the privatization process with DTT through sharing common office space, our work consists of the following.

- We supported CSFB – the investment bank working with the State Property Fund on the privatization sale – by reviewing and commenting on the information

memorandum supporting the sale of distribution assets in the first privatization batch.

- We frequently review and comment in detail on various instruments of the privatization process, including CabMin resolutions, tender notices, draft presidential decrees, and other materials.
- We provided CSFB with legal texts translated into English and advised CSFB on certain Ukrainian legal issues. Along similar lines, we routinely provide DTT with English-translated copies of laws and other normative acts for use in its privatization web site.
- We regularly meet with potential strategic investors to explore their views and privatization participation requirements, passing relevant information to DTT and incorporating the same into our work.
- We are leading, together with EBRD, the international donor community efforts to implement the appointment of a trustee for the regional and central transit accounts through which all power sector funds flow, a key concern expressed by potential strategic investors.
- We actively work with DTT to create a dialogue on and resolution to the sector debt problem. In connection with this effort, we provided counterparts with written analyses of possible debt solutions (e.g., “Brady Bond” models).

## **E. RELATIONSHIPS WITH THE INTERNATIONAL TASK FORCE**

As we previously mentioned, GOU and the principal international donor agencies in Ukraine – EBRD, IMF, the World Bank and USAID – created an international energy Task Force to tackle problems with the Ukraine power sector. The decisions of the Task Force routinely shape and guide the directions of our Project.

Within the Task Force, USAID plays a key role directing Task Force activities, including drafting concept papers summarizing the group consensus (or seeking to attain such consensus). Hunton & Williams supports USAID’s Task Force activities by assisting with concept paper development as well as working to implement the short-, medium- and long-term goals of the Task Force. One recent success where we took a Task Force idea, developed it and implemented it is the appointment of an auditor from the “Big Five” international auditing firms to audit the flow of funds through the transit account mechanism. Hunton & Williams directly support this effort by developing the terms of reference for the auditor and then working with EBRD, the WEM Board, and the Energomarket to select and contract the auditor.

## **F. TRAINING PROGRAM**

Hunton & Williams expects to developed a focused training program to support Project objectives. We shall discuss this in more detail in our November Quarterly and Inception Report.